

STATE BOARD OF LAND COMMISSIONERS

Dirk Kempthorne, Governor and President of the Board
Pete T. Cenarrusa, Secretary of State
Alan G. Lance, Attorney General
J. D. Williams, State Controller
Marilyn Howard, Superintendent of Public Instruction

Winston A Wiggins, Secretary to the Board

Final Minutes Regular Land Board Meeting September 10, 2002

The regular meeting of the Idaho State Board of Land Commissioners was held on Tuesday, September 10, 2002 in Boise, Idaho. The meeting began at 9:02 a.m. The Honorable Dirk Kempthorne presided. The following members were present:

Honorable Secretary of State Pete T. Cenarrusa
Honorable Controller J. D. Williams
Honorable Superintendent of Public Instruction Marilyn Howard

Secretary to the Board Winston A Wiggins

Attorney General Alan Lance was absent from this meeting.

• **CONSENT AGENDA**

Director Wiggins provided background information on the Consent Agenda items.

A motion was made by Controller Williams to approve the Consent Agenda in its entirety. Secretary of State Cenarrusa seconded the motion. The motion carried on a vote of 4-0, with Attorney General Lance being absent for this vote.

1. Director's Report – approved

- A. Bureau of Real Estate, Land Sale Section, Official Transactions – August 2002
- B. Bureau of Real Estate, Easement Section, Official Transactions – August 2002
- C. Bureau of Surface and Mineral Resources, Range Management and Surface Leasing Section, Official Transactions – August 2002
- D. Timber Sale Official Transactions – August 7, 2002 through August 27, 2002
- E. Timber Sale Activity Report
- F. Fire Report

FIRE REPORT: Director Wiggins stated the total for deficiency warrants is \$3.7 million, with \$1 million reimbursable and \$2.7 million to the General Fund under Deficiency Warrants/Fire Suppression. \$500,000 of that amount is a holdover to cover late bills from fiscal 02.

Governor Kempthorne commented that the state has fared well this year as compared to last year despite the fact that conditions have been dry. This morning the sixteenth drought declaration was signed for Caribou County. Director Wiggins stated that the department has had a number of employees working on fires all over the western United States – from Alaska to Arizona, Colorado and Utah. He agreed that the state has been fortunate this year.

- G. Interest Rate on Department Transactions – September 2002

2. Timber Sales – Staffed by Bob Helmer, Chief, Bureau of Forest Management – approved

A. Two Knob Thin	CR-1-0327	3,720 MBF
B. Morris-Clug	CR-3-0475	5,325 MBF
C. Powderhouse Sanitation	CR-4-0733	2,300 MBF
D. Maggie Breaks Pulp	CR-4-0738	7,350 MBF

DISCUSSION: On a side note, Governor Kempthorne commented that the majority of trees at Red Fish Lake are dead. He feels the area may look like a clearcut when the trees are removed. He asked Director Wiggins what the outlook for the area will be. Director Wiggins stated that Red Fish reflects the natural progression of that type of stand, if it is not managed. The trees ultimately reach an age of decline. The trees are thick and compete for moisture and nutrients and are susceptible to bug infestation. However, when the dead trees are removed, regeneration will occur. There will be a sea of young trees coming up from underneath, or afterwards, if it is managed correctly. The cycle will start over again. Ideally active management would take place in an attempt to bring the stand into a healthy state and then maintain it in that way. The unfortunate side of that is that management includes a variety of treatments, which could involve cutting trees, and that will be controversial on federal lands. This is a normal cycle of those types of stands and it points out why it is important, not only from a money standpoint, but from an aesthetic standpoint in recreation areas, that there actually is some active management of timber stands.

Governor Kempthorne asked if, through active management, a variety of tree species will be planted. Director Wiggins responded there should be. The stands that are most resilient to various pathogens are the ones that have a mix of species.

Dr. Howard noted that on the Maggie Breaks Pulp Sale it appears some of the faster growing trees are the larger trees, such as Grand fir. Grand fir grows faster and actually shades out some other types of trees that might come in. She asked if there is a way to work with that issue. Director Wiggins responded that typically forest stands go through a progression. You have what is called seral, or species that like to live in the sunlight. Those trees are not tolerant to shade coming in, and that includes Douglas fir and western white pine, which are fast growing trees. Grand fir will also come in. The difference is as the trees grow and age, Grand fir is tolerant to shade. Ultimately over time Grand fir will shade out the other species. Then you move toward what we call a climax, which is a stand that is dominated by species that are tolerant to shade because they can self-perpetuate over time, and that includes Grand fir and cedar. The volume that is reflected on this particular site indicates this stand has progressed a long way toward that condition. Out of seven million feet, four million feet is Grand fir and cedar, which is shade tolerant. Nearly three million feet is in pulp and that is going to be almost all Grand fir. This stand has progressed a long way toward climax, which makes it in the same state as Red Fish, even though this stand is a different timber type. The trees are old and diseased. Something needs to be done now to bring the stand back into a good managed state or the stand will just fall down.

3. Conceptual Approval for State/Hitchcock Land Exchange – Staffed by Perry Whittaker, Chief, Bureau of Real Estate – approved

DEPARTMENT RECOMMENDATION: That the board approve the department's recommendation to complete a balanced land exchange package and return to the board for final approval.

BOARD ACTION: Approved.

4. Results of Grazing Lease Auctions – Staffed by Tracy Behrens, Range Management Specialist – approved

DEPARTMENT RECOMMENDATION: That the board accept the high bids submitted at the auctions for leases G4035, G4566, G6132 (auction #1), G6132 (auction #2), G6225, G8114, G8579, G8743 (auction #1), G8743 (auction #2), G8744, G8745, G9586, G9780 and direct the department to issue new ten-year grazing leases to the highest bidders. Each lease will include a summary of the grazing management proposal submitted by the high bidder and accepted by the Department.

The department also recommends that, in accordance with IDAPA 20.03.14.105.04 Appearance (at conflict auctions), Mr. Calligan's first year rental deposit of \$651.60 for lease G4035 and \$282.36 for lease G4566 be forfeited to the state.

BOARD ACTION: Approved.

5. Contract Modification, Anchors Away OSR Timber Sale, TS-3-3286 – Staffed by Ron Litz, Assistant Director, Forestry and Fire – approved

DEPARTMENT RECOMMENDATION: That the board direct the department to modify this contract.

BOARD ACTION: Approved.

6. August 20, 2002 Regular Meeting Minutes – approved

• REGULAR AGENDA

7. Department of Lands Budget – Presented by Winston Wiggins, Director

Director Wiggins introduced the department's new Fiscal Officer, Mel Landers. Mr. Landers was formerly the Controller for TJ International. Governor Kempthorne welcomed Mr. Landers.

DEPARTMENT RECOMMENDATION: That the board direct the department to forward the proposed FY-2004 budget to the Legislature for consideration.

DISCUSSION: Governor Kempthorne asked Director Wiggins if he desired board action on the department budget. Director Wiggins stated yes.

Controller Williams asked about building costs for the Priest Lake office. He suggested an innovative approach would be to take cottage sites at McCall and trade those sites for the Priest Lake building. Then the department would pay rent to the Endowment, which would probably be a substantial increase to the Endowment over the 2.5% for the cottage sites. Director Wiggins stated the department will consider that option. Controller Williams stated he did not object to this budget item being left in the department's budget proposal.

BOARD ACTION: A motion was made by Controller Williams to accept the department's recommendation. Secretary of State Cenarrusa seconded the motion. The motion carried on a vote of 3-0, with Controller Williams, Secretary of State Cenarrusa and Superintendent Howard voting aye; Attorney General Lance was absent for this vote; Governor Kempthorne abstained from this vote.

8. Endowment Fund Investment Board

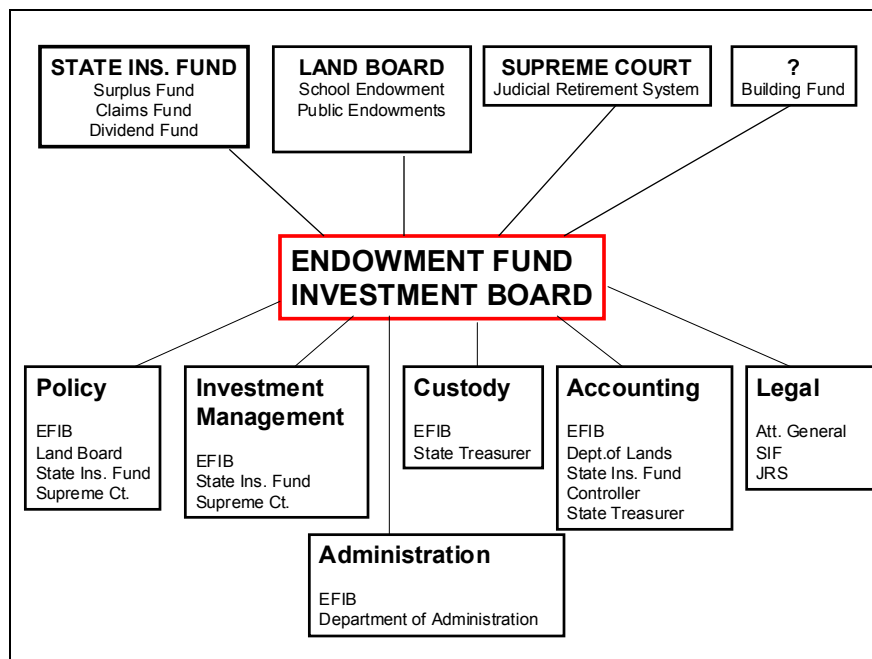
Governor Kempthorne welcomed the members of the Endowment Fund Investment Board. Members present included: Representative Bill Deal, Dr. Nick Hallett, Dean Buffington, Parker Woodall, Tom Kealey, John Taylor. Endowment Board members absent: Bill Mitchell, Senator Dean Cameron, Gavin Gee.

Governor Kempthorne also acknowledged the presence of Jody Olson, Chairman, PERSI Investment Fund; Kathy Phelan, President, Idaho Education Association; Terry Gilbert, Idaho Education Association; Michael Friend, Executive Director, Idaho Association of School Administrators; Beth Young, Idaho Congress of Parents and Teachers.

A. EFIB Board General Discussion with the Land Board

Bob Maynard, PERSI, discussed the roles and responsibilities of the Endowment Fund Investment Board.

Chart One – Endowment Fund Investment Board Structure



The Endowment Fund Investment Board is the investment arm for four separate state entities. These state entities are independent of each other.

1. State Insurance Fund. The State Insurance Fund is a state corporation that is independent from the rest of state government. It is basically a private corporation not beholden to anyone else.
2. State Board of Land Commissioners. The Land board is responsible for the school and pooled endowments.
3. Judicial Retirement System. The Judicial Retirement System is under the auspices of the Supreme Court.
4. Building Fund.

Managing the infrastructure for these investments has been identified as a problem. The EFIB does not have control over all aspects of its infrastructure. An investment program manages investment policy, managers, where money is being invested, who holds the money, what the custody relationship is, accounting and reporting for all of the various accounts, legal issues with investments and with the programs themselves, contracts, relationships and matters of that nature. The EFIB has the responsibility for making sure everyone is doing their jobs even though they do not have direct control.

Chart 2 – Investment and Investment Management

	Land Board	State Ins. Fund	Jud. Ret. Sys	Building Fnd
POLICY				
Goals	1	1	1	4
Major Asset Types	2	1.5	(2)	4
Allocation	2	1.5	(1.5)	4
Tilts and Special	2	1.5	3	4
IMPLEMENTATION				
Active vs. Passive	2	1.5	1	4
Outside vs. Inside	3	2	(3)	4
Consulting	1.5	1	1.5	4
Manager Selection	2	1.5	(3)	4
Portfolio Risk Cont	3	3	3	4
Internal Risk Cont	4	3	Na	4
Accounting/Cash Flow	1.5	1	1	4
Outside Auditor	4	4	4	4
ADMINISTRATION				
Custody Relationship	4	2	1.5	4
Budget	2	3	4	4
Personnel	1.5	3	4	4
Equipment/Space	4	4	4	4
Legal Reviews/Issues	1.5	2	1.5	4
EFIB REPORTING				
Performance	X		X	
Cash Flow/Accounting	X			
Earnings Reserve	X			
Projections	X			
Statutory Loss	X			
Risk Control Info			X	
Characteristics			X	
Transactions			X	

"1" - Decision rests with the client. EFIB assists in the decision.
 "2" - Decision delegated to EFIB, but Client wants intense involvement and reporting
 "3" - Decision delegated to EFIB, Clients wants only occasional involvement or cursory reporting.
 "4" - Client not involved or has expressed no interest.
 "()" means that the statutes require formal Supreme Court approval

This table shows investment operation issues. The EFIB must find a structure that allows it to be flexible with regard to the client's particular levels of interest. The numbers on this chart may change over time as various issues arise or as levels of client comfort increase.

DISCUSSION: Governor Kempthorne asked Mr. Maynard if Chart 1 is as it should be. He asked if the chart evolved over time and is there a better system that could be devised. Mr. Maynard responded that the system is workable, but he believes it could be made to be transparent.

Governor Kempthorne noted there are five entities listed under Accounting. He asked if a savings might be realized if audits were consolidated into one. Mr. Maynard responded possibly yes, but department, Treasurer and EFIB lines would have to be crossed and that would be difficult to do.

Governor Kempthorne asked Representative Deal if it serves a good dual purpose to have someone who is on the State Insurance Fund Board also serving on the EFIB as a conduit back. Representative Deal responded in his case it was not set up that way directly. However, he feels it has worked well.

Controller Williams asked about models used by other states. He asked if there is any value in the idea of investing being totally centralized. Mr. Maynard responded while there is something to be said for the idea of being totally centralized, reporting would be a problem. The more you centralize the investment operation, the more difficult the job becomes for the people overseeing the operation. Every investment operation is based solely around the investment objectives of the particular funds being managed. The objective of the EFIB is different than the objective of PERSI or the State Insurance Fund or the Judicial Retirement System. Centralized operations start to fail when the overseeing board does not fully understand the objectives of the underlying funds and therefore tries to force one size to fit all. It is a communication and focus problem on the part of the overseeing group. There is no perfect system. You fit the investment operation to the people and to the structures you find rather than try to force the people and the structures to fit what you think may be a perfect investment operation. Mr. Maynard stated as interim manager he intends to bring up these issues and then find some way to get a communication between the boards to resolve the issues.

The main issue is to review the spending policy in light of current markets and different timber projections. Another issue is figuring out the kinds of reports and outside comments required by the board from either consultants or other experts. The final area is the board's interest in active/passive management and the managers.

Mr. Woodall commented the EFIB is committed to making sure the job gets done. If it does not get done, then the EFIB needs to ask questions. If it is not being done because the questions were not asked properly, the EFIB board needs to know that too. Mr. Woodall believes the system will work until a better way is determined. The EFIB is committed to improving communication with its clients and determining its clients' needs.

Dr. Hallett stated the EFIB has almost completed an important first step. That first step was to define the relationships and issues. The next step is to resolve those issues taking into account the interests of the various clients.

Mr. Buffington observed one of the reasons this looks so confusing is the tremendous change in investment policy that occurred four or five years ago. Before that time all of the funds were invested in fixed incomes and securities. Most of those monies were invested by in-house personnel. The confusion began when a switch to equities was made and outside managers were hired. Some of those issues have been defined.

Governor Kempthorne commented that Chart 2 reflects a good rating system. He believes over time the numbers will change by category. There are certain items that need the board's attention right now and those items are going to have a number one. But once things start operating as hoped, some of the categories will move to management by exception. We are now focusing on true responsibility and respective roles. If there is a different way to proceed, we may want to discuss ideas and make it happen.

No action was taken on this agenda item.

B. Endowment Fund Performance Report – Presented by Bob Maynard, PERSI

Bob Maynard, PERSI, provided a performance report for the board.

Mr. Maynard presented the return of the financial trust through the September 9, 2002 market closing. Financial assets began the year with a value of \$682,000,000 and are now down to \$625,118,087. Payouts to public schools occur in July and February.

Mr. Maynard stated there is a potential cash flow issue in the public school account next July if the markets do not come back. If the markets come back, the problem will disappear because all of the gains are deposited into the earnings reserve. If the market does not come back, there are a number of ways to potentially work through the issue, including how to figure exact distribution needs. Fiscal year to date, the total fund is down 6% for an investment gain/loss of just under \$40 million.

The allocation now is 63% U.S. equities, 36% fixed income and cash. Rounding would bring this percentage to 100%. The current allocation is below the 70/30 underlying allocation the EFIB set as the strategic allocation. The EFIB will begin reviewing this issue.

DISCUSSION: Governor Kempthorne asked if the numbers would have been the same if the funds had remained in all fixed income. Mr. Maynard responded returns would have been similar. Governor Kempthorne asked if there still would have been a revenue decline. Mr. Maynard stated if the policy had not changed, the returns would have been more along the lines of returns experienced over the longer term, which are positive even though they are below the benchmark. If the statute had not changed, the distribution would have been lower. The statute allowed the board to pull all of the land trust and financial assets into one big pool. Because over half of the assets are from timber revenue, the impact of this side alone is less. You have actually done two things. One is you increased the distribution quite substantially from what it was previously, and two, under the old system, most of the cost of running the Department of Lands and the EFIB came out of General Fund revenues. That number is around \$16 million to \$17 million per year. That dollar amount has been shifted to the Endowment. Not only has the distribution to the beneficiaries increased, the burden on the General Fund decreased as well. By following the system now in place, you are still ahead of where you were under the old system.

Governor Kempthorne noted that the board entered the new investment strategy right before the worst market in 50 years began. In hindsight, Governor Kempthorne asked if the board made the right decision by entering into equities. Mr. Maynard responded it is very rare to see a long-term investment program that keeps consistent watch on a base structure go awry. There will be periods of bad returns and good returns.

Following up on the topic, Governor Kempthorne asked Mr. Maynard if, as a policy change, he would still recommend going into the equity market. Mr. Maynard responded there is a need to keep pace with inflation and, in that environment and that type of liability, equities are safer in the long term than bonds. As a policy matter, there is no question. The distribution increased and you now have the ability to protect the fund and distributions against inflation for the next ten to twenty years.

Dr. Howard noted that one of Mr. Maynard's comments had to do with an expense shift from the General Fund to the Endowment. She commented in a sense the General Fund has been relieved of over \$16 million of expense. That expense will be an ongoing expense into the future and those expenses will increase. Also, timber is being treated differently as to

how those monies enter the pooled account. She asked what the long term impact will be for returns to the fund. Mr. Maynard stated there are two impacts to be considered. First, if the long-term equity markets come back to what they traditionally had over this 15-20 year period of time, the loss, plus more, will be made up by simply being in fixed income. However, if you are looking at the next 5-10 year timeframe, that may not occur. There is a good chance in 10 years you could get back to where you were. That depends on the equity markets. It is not so much simply getting into equities that caused the change. The big issue was managing both sides of the endowment for investment purposes as a whole. That is why the overall policy was shifted to the Land Board. The policy allowed the Land Board to look at the financial and land assets in the same manner. It allowed the board to manage the land assets for return, as well as for biological proof and other items. The history of the markets has always been that over a 20-25 year timeframe, losses will be regained.

Controller Williams commented the timing for entering into equities was bad. However, remembering when he became a member of the Land Board, which was March 1, 1981, the corpus of the endowment stood at \$335 million. Today the corpus is approximately \$620 million, almost \$300 million more. The increase resulted from the policy of putting timber cash into the fund. Controller Williams believes the board is on the right course. Mr. Maynard stated distributions to the beneficiaries have increased substantially over the past five years. Even with a potential drop over the next year, distributions are still higher than they were before this policy was put into place. The issue is can you build the fund higher for future generations, which is part of the board's issue. The answer depends on the management of the timber and the equity markets. History has tended to say yes, you will be able to build the fund for the future. But it is tough to say now based on the market performance for the last two years.

No action was taken on this agenda item.

At 10:30 a.m., a motion was made by Controller Williams to resolve into Executive Session. Secretary of State Cenarrusa seconded the motion. The motion carried on a vote of 4-0, with Attorney General Lance being absent for this vote.

- **EXECUTIVE SESSION**

- A. To Consider and Advise Its Legal Representatives in Pending Litigation or Where There is a General Public Awareness of Probable Litigation** [Idaho Code § 67-2345(1)(f)]

- B. To Consider Personnel Matters** [Idaho Code § 67-2345(1)(b)]

At 12:05 p.m., a motion was made by Controller Williams to resolve into Regular Session. Superintendent Howard seconded the motion. The motion carried on a vote of 4-0, with Attorney General Lance being absent for this vote. No actions were taken by the board during the Executive Session.

There being no further business to come before the board, the meeting adjourned at 12:08 p.m.

IDAHO STATE BOARD OF LAND COMMISSIONERS

/s/ Dirk Kempthorne

President, State Board of Land Commissioners and
Governor of the State of Idaho

/s/ Pete T. Cenarrusa

Pete T. Cenarrusa
Secretary of State

/s/ Winston A Wiggins

Winston A Wiggins
Director

The above-listed final minutes were approved by the State Board of Land Commissioners at the October 8, 2002 regular Land Board meeting.